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BEFORE THE ARIZONA CORPORATION COMMISSION

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CARL J. KUNASEK
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DOCKET NO. U-00000C-94-165

IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

NOTICE OF FILING OF REPLY
BRIEF OF THE ELECTRIC
COMPETITION COALITION

NOTICE is given that the Electric Competition Coalition (ECC), Enron Corporation and Enron Energy Services, Inc. filed their Reply Brief.

RESPECTFULLY submitted this 23rd day of March, 1998.

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IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. U-00000C-94-165

REPLY BRIEF
ON BEHALF OF
ELECTRIC COMPETITION COALITION,
ENRON CORPORATION, AND
ENRON ENERGY SERVICES, INC.

MARCH 23, 1998

**REPLY BRIEF
ON BEHALF OF
ELECTRIC COMPETITION COALITION**

MARCH 23, 1998

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1 The Electric Competition Coalition ("ECC"), the Enron Corporation, and Enron Energy
2 Services, Inc. (collectively referred to herein as ECC) submit this Reply Brief in this proceeding.

3
4 **I. Competition Must Be Assured Under the Strandable Cost Program**

5 The Electric Competition Rules, as the name states, are to ensure that competition occurs
6 in a prompt and effective manner. Consumer protection is assured by the ability for new
7 entrants to actively and efficiently participate in new markets. Several participants in this
8 proceeding, in addition to ECC, underscored the necessity of linking strandable cost recovery
9 to the opening of a viable competitive market.¹ The Rules emphasize that stranded cost recovery
10 is conditioned on the impacts it may have on prices paid by consumers who purchase competitive
11 generation and its impact on the effectiveness of competition, as two of the 11 factors.²
12 Consumers and new entrants should be assured that competitive generation will be available
13 before any strandable cost program is approved by the Commission.

14 **II. Divestiture Is the Most Accurate, Efficient and Least-Cost Approach**

15 The record establishes the divestiture approach as providing the most accurate value of
16 strandable assets and the price of "market" generation in Arizona. The Commission's Staff and
17 the Residential Utility Consumer Office ("RUCO") expressed concern that divestiture would still
18 require an administrative approach.³ ECC urges that any Commission oversight would be within
19 narrow parameters, requiring limited administrative involvement. For example, the company
20

21 ¹ See, e.g., *Arizonans for Electric Choice and Competition, et al.* Initial Brief at
22 6 ("AECC"); Department of Defense Opening Brief at 2 ("DOD"); PG&E Energy
23 Services (Testimony of Douglas Oglesby) Transcript 1350:15-22; ECC Initial Brief at 33-
24 34. References to the Hearing Transcript in ECC's Initial and Reply Briefs are to pages,
with lines of reference following the colon.

25 ² A.A.C. R14-2-1607(D)(1) & (4) and (I)(1) & (4).

26 ³ Staff's Opening Brief at 10 ("Commission Staff"); RUCO Initial Brief at 7-8
27 ("RUCO").

1 could file its divestiture plan for Commission approval before soliciting bids, so as to establish
2 acceptable parameters and ranges of bids for the sale. As Enron witness Ms. Mona Petrochko
3 testified:

4
5 What I would suggest is that prior to entering into the process
6 of selling the assets, that the utility should submit a plan to the
7 Commission that would identify how the utility plans to go
8 about selling those assets, if there are going to be any costs
9 associated with selling those assets, if there's going to be
10 provisions to sell power back for must-run conditions or
11 whatever under that contract, and what would be an acceptable
12 range of value for those assets before proceeding with the sale.

13
14 And what that does is it provides the asset owner with some
15 framework from which to evaluate bids. It also provides people
16 who are interested in bidding on believing that their bid has
17 some meaning, so that if you come forward with an offer to
18 purchase, that you can proceed and conclude that transaction
19 without having it becoming unraveled by the Commission.⁴

20
21 Divestiture proposals from the utilities can be structured so as to "do no harm," as
22 requested by RUCO and other consumer organizations.⁵ Generation prices at the plant are not
23 subject to price discrimination; prices in the competitive environment are set by the ability of
24 new entrants to enter the market and the consumers willingness to pay. The Standard Offer,
25 with a total rate cap during the transition, will serve as the "backboard" for all electric
26 consumers. For these reasons, ECC strongly urges that the ease of generation market entry be
27 assured and that all consumers be encouraged to aggregate their loads so as to pursue more
28 attractive prices. With divestiture, residential and small consumers would be pursued by the
plants' new owners. Therefore, those customers would receive lower cost power earlier than
under other approaches. Consumers should be assured that the benefits of electric restructuring

25 ⁴ Ms. Mona Petrochko, Transcript 948:7-25.

26 ⁵ RUCO at 1; Arizona Community Action Association Initial Brief at 3; and
27 Arizona Consumer Council Brief of Albert Sterman at 1.

1 flow to their residences and businesses, in both urban and rural Arizona, through open access
2 and aggregation.

3 The benefits of divestiture are many.⁶ Perhaps the singular most important advantage is
4 that bidders are required to carefully evaluate the net present value of the plant over its useful
5 life and compare that value to its own future generation market projections, and then pay "real
6 dollars" to back its projection and absorb the risks of mitigation (without the benefits of a true
7 up), fuel costs, inflation, and changes in other regulatory environments. The divestiture
8 approach "collapses" the useful generation life of the plant into one transaction so as to derive
9 the net strandable cost over the life of the plant. Thus, one need not address the distinction of
10 the plant's useful life and the recovery period, as suggested by RUCO.⁷ These cost efficiencies
11 must be implemented by the new owner, otherwise customers will purchase from other lower
12 cost generation providers. It is important to keep in mind that the customers may buy from a
13 new entrant or another existing utility in Arizona. These options create enormous pressure on
14 generation competitors to keep their costs and prices down. This is the essence of ease of access
15 for true competition to occur. Furthermore, these risks will be absorbed by shareholders and
16 not the consumers. Consistent with this rationale, the recovery period could, and should, be no
17 later than when full open access is available to all customers -- January 1, 2003.

18 Another major advantage of divestiture and the resulting competitive generation market
19 is that the necessity of a rate freeze or price cap may not be necessary. Some suggest that such
20 a freeze or cap may be confiscatory and violate the Commission's constitutional duties.⁸ To
21 resolve this issue, the Rules provide for the unbundling of rates which would be under the

22
23 ⁶ See Citizens Utilities Company Initial Brief at 16-19 ("Citizens"); DOD at 5-6;
PG&E Energy Services Initial Brief at 8-9 ("PG&E Energy Services").

24
25 ⁷ RUCO at 3 & 8 (RUCO expressed specific concern about APS collecting positive
26 annual stranded costs in the near term, through 2006, and gain from negative stranded
costs thereafter from the useful life of the asset.).

27
28 ⁸ Arizona Electric Power Cooperative, Inc. Initial Brief at 11 ("AEPCO").

1 Commission's reasonable return on the fair value of those unbundled assets. The bundled rate,
2 or the Standard Offer, could be fixed, similar to present rate making processes. No price cap
3 would of course be necessary on competitive generation and the unbundled, non-generation
4 components should not be frozen, particularly if those costs go down over the next five years.
5 With the separation of generation, the costs of transmission, distribution and ancillary services
6 will likely go down because of less risk in recovering revenues associated with the continuing
7 monopoly transmission and distribution business, and the competitive pressures on rates
8 associated with metering, billing and ancillary services.

9 The Commission may require divestiture as a condition of strandable cost recovery under
10 the broad constitutional ratemaking and classification authority, according the Commission's
11 Staff.⁹ If the divestiture approach is not adopted as the method for recovery of strandable costs,
12 ECC strongly encourages the Commission to include it as a preferred approach. Certainly other
13 jurisdictions, such as California and New York, have included incentives for utilities to divest
14 of generation assets.¹⁰

15 **III. Divestiture Resolves the Horizontal Market Power Issue**

16 Under the present Arizona structure, horizontal market power occurs with Affected
17 Utilities owning and controlling the prices of generation.¹¹ The Affected Utilities already own
18 or largely control transmission. New entrants must either purchase wholesale generation or
19 build new plants in order to compete in Arizona. Without divestiture, the Affected Utilities will
20 control generation prices and the pace of competition in Arizona.

21 Some have expressed concern that asset sales may lead to horizontal market power
22 concentration. Although ECC believes this to be unlikely, the Commission could address any

23
24 ⁹ Commission Staff at 10.

25 ¹⁰ PG&E Energy Services Douglas Olgesby, Transcript 1255:19 to 1256:18.

26 ¹¹ See Ajo Improvement Company *et al.* Initial Post Hearing Brief at 28-29
27 ("Ajo").

1 horizontal market power when structuring the sale. Furthermore, the asset sale must be
2 reviewed and approved by the Federal Energy Regulatory Commission and must comply with
3 all state and federal antitrust laws. Very likely the Affected Utilities will create nonregulated
4 affiliates so that they may qualify as bidders. These "arms length" transactions create a clean
5 separation of costs, revenues and generation market values.

6 **IV. The Market Values of Generation Assets Are Ignored Under the Utilities' Proposals**

7 The administrative net revenue lost approach loses sight of the value of any strandable
8 generation asset. Many peripheral issues and factors are brought into the equation. Because of
9 the "wide open door" of assumptions, data sources and methodology, the net revenue lost
10 approach will be contentious and perhaps lead to protracted litigation, uncertainty and delay.
11 This only benefits the Affected Utilities, and harms the Arizona consumer and new entrants.

12 Many agree that generation assets may have considerable value after any stranded cost
13 recovery period proposed in this proceeding.¹² For example, the very large 3600-megawatt Palo
14 Verde Nuclear Generating Station is a low marginal cost resource in the western United States.¹³
15 The net revenue lost approach requires the Commission to address how risks and rewards are
16 to be shared between shareholders and consumers, after the transition period. The divestiture
17 or appraisal approach focuses on the true market value of those assets and precludes the utility
18 from profiting from both the transition and the ownership of generation plants.

19 **V. Functional and Operational Separation Must Be Addressed**

20 Vertical market power is evident in the monopolistic control over generation,
21 transmission, distribution and ancillary services. In order for new entrants to participate
22 effectively, the functional and operational separation of these activities must be clearly set forth.

23 The initial step has occurred with the functional and operational separation of transmission,
24 under orders of the Federal Energy Regulatory Commission. The Arizona Corporation

25 ¹² *Concurs* Citizens at 19-21.

26 ¹³ RUCO at 20.

1 Commission has taken a partial second step by requiring the unbundling of rates. Divestiture
2 would separate regulated distribution activities from competitive market functions of the utility.
3 It removes the incumbent utility of competitive advantages associated with vertical integration
4 and expedites the Commission's efforts in recognizing the competitive price of generation. The
5 mere accounting segregation of numbers is not sufficient to assure new entrants of
6 anticompetitive practices, such as through the sharing of information (and potentially costs and
7 revenues) between the regulated and nonregulated activities of the utility. These concerns have
8 been expressed by many in this proceeding.¹⁴

9 ECC shares RUCO's concerns about cost-shifting associated with improper unbundling
10 of costs between competitive generation. ECC concurs with RUCO's recommendation that
11 unbundling take place before strandable costs are calculated.¹⁵ Furthermore, ECC urges that any
12 strandable cost recovery program require the functional and operational separation of the
13 Affected Utilities' transmission, generation, distribution and ancillary services. Maine and
14 Nevada, for example, have addressed this separation of competitive services from regulated
15 services, and New York, New Jersey, Maryland, Wisconsin, Rhode Island, New Mexico and
16 California have adopted affiliate standards of conduct.¹⁶ ECC urges that these issues be
17 addressed immediately so as to give new entrants a fair opportunity to compete in Arizona.

18 **VI. Nuclear Plant Decommissioning and Nuclear Fuel Disposal Are Components of**
19 **Generation Costs**

20 RUCO claims that nuclear decommissioning costs and nuclear fuel disposal costs are
21

22
23 ¹⁴ Arizonans for a Better Environment Supplemental Initial Brief at 2
24 (Administered costs to consumers should be allocated so as to send "accurate and
25 appropriate price signals to the various classes of consumers."); DOD at 8; PG&E
26 Energy Services 6-7.

27 ¹⁵ RUCO at 11-12.

28 ¹⁶ Ms. Mona Petrochko Direct Testimony at 24-25.

1 directly related to generation and should be included as strandable cost.¹⁷ ECC believes the
2 reasoning set forth by RUCO on pages 14 through 16 of its Initial Brief has merit. In addition,
3 a separate consumer charge for nuclear decommissioning and nuclear fuel costs would be a
4 subsidy by Arizona consumers in the competitive marketing of nuclear power throughout the
5 Western United States. New entrants would have to compete against low marginal cost of
6 nuclear power and the subsidized nuclear benefits charge paid by Arizona consumers.

7 **VII. ECC Supports the Positions of Certain Other Parties on the Regulatory Compact**
8 **Issue**

9 In addition to the earlier arguments made by ECC, it supports and adopts the arguments
10 of the Commission Staff, RUCO, the Arizonans for Electric Choice and Competition *et al.*, and
11 Ajo Improvement Company, *et al.* as presented in their Initial Brief on the issue of a regulatory
12 compact.¹⁸

13 Citizens Utilities Company cites a ruling by the Hawaii Public Utilities Commission
14 involving Citizens' Kauai Division, involving storm-related restoration costs from Hurricane
15 Iniki. The notion of a regulatory compact in that case has no applicability to the strandable costs
16 of generation due to technological and market changes in the industry or to the facts presented
17 in this Arizona hearing. Restoration of storm-damaged facilities is far different from addressing
18 the strandable and residual values of generation facilities in a competitive market. According
19 to Citizens, the Hawaii addressed the obligation to serve "after a mammoth natural disaster."¹⁹
20 The "duty" to provide monopolistic electric distribution infrastructures is not an issue in this
21 proceeding. Citizens will still own and recover regulated rates for use of its distribution system.
22 The reliance on this case illustrates how any notion of any reciprocal relationship may be
23

24 ¹⁷ *Concurs* PG&E Energy Services at 5.

25 ¹⁸ Commission Staff at 13-22; RUCO at 5; AECC at 22-28; and Ajo at 2-8.

26 ¹⁹ Citizens at 3.

1 broadly misinterpreted as creating a "compact" or "contract" against any changes affecting the
2 utility. Furthermore, the Hawaii PUC hinged its decision on a legislatively enacted statewide
3 surcharge if there would be a rate increase of 15 percent for the average residential ratepayer
4 in the service area. The Hawaii statute required the PUC to first consider to what extent the
5 shareholders and ratepayers are to share in restoration costs. The Arizona Legislature has not
6 enacted a statewide surcharge. Nor does is the PUC a constitutionally created body similar to
7 the Arizona Corporation Commission. The Hawaii PUC ruling should not be adopted as a
8 precedent for any decision in this proceeding.²⁰

9 **VIII. Conclusion**

10 After 45 months of study, working groups and deliberation, ECC believes it is time for
11 the Commission to move forward. The Affected Utilities "hold the cards" on what they believe
12 to be their strandable costs. The Rules require the utilities to file their unbundled rates²¹ and
13 provide estimates of their strandable costs using "records of market transactions undertaken by
14 willing buyers and willing sellers."²² Thereafter, the Commission may review the Affected
15 Utilities estimates and apply the 11 factors set forth in A.A.C. R14-2-1607(I), which include the
16 impact of stranded cost recovery on the effectiveness of competition and the prices paid by
17 consumers who participate in the competitive market. ECC believes the Commission may
18 encourage divestiture as the preferred approach, when applying the 11 factors and ECC urges
19 the Commission to require all Affected Utilities to set forth any reason why divestiture is not
20 an appropriate first alternative.

21
22 ²⁰ Citizens Exhibit A.

23 ²¹ A.A.C. R14-2-1606(C).

24 ²² A.A.C. R14-2-1607(G) ("The Affected Utilities shall file estimates of
25 unmitigated Stranded Costs. Such estimates shall be fully supported by analyses and by
26 records of market transactions undertaken by willing buyers and willing sellers.") and -
27 1607(K) ("The Commission may order an Affected Utility to file estimates of Stranded
28 Cost and mechanisms to recover or, if negative, to refund Stranded Costs.").